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EARNINGS MANAGEMENT IN BANKS: EMPIRICAL EVIDENCE FROM INDIA

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ABSTRACT

This research work investigates the existence of earning management practices in Indian banks, specifically those belong to public and private sectors. Public sector banks are perceived to be more sensitive towards the different pressures of capital market, resultantly their share prices are more influenced by the reported earnings. Therefore, people expect that banks those belong to public sectors are more indulged in the earning management practices in comparison to its counterpart (private sector banks). This research work measures earnings management thorough discretionary loss loan provisions. Based on the sample of 30 Indian banks spanning over 8 years from 2010 to 2017, we find that, on average, public companies are less likely to be engaged in earnings management consistent with the prediction of analysts coverage and regulations hypothesis. We use profitability ratios, as a control variable to ensure that our results are not driven due to fundamental differences between private and public banks. Contrary to the earlier studies where the focus was only earning management in banks of public sector, results mentioned in this study expand the existing body of knowledge, by providing results to the private sector banks& public sector bank. These provided results help us to understand the magnitude and forms of earning management at the private sector& public sector banks of India.

KEYWORDS: Earning Management, GAAP, LLPs (Loan Loss Provisions) & Performance

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Original Article

1. INTRODUCTION

Earnings management is defined as intentional manipulation of accounts by managers with the constraints of Generally Accepted Accounting Principles (GAAP) to fulfil their contractual outcomes. Executives may increase or decrease the reported income to demonstrate the firm's performance and obtain higher compensation related to the future sock performance of the firm. Therefore, earnings management practice can be beneficial or harmful for the firm's performance, accordingly it is classified as earnings in formativeness or earnings efficiency and earnings manipulation or earnings opportunism. According to agency theory of (Jensen and Meckling, 1976), the separation between managers as an agent of the firm from owners (shareholders) creates a clash between the interests of management and shareholders. Managers normally try to exploit their personal interest even at the expense of shareholders. This conflict of interest between shareholders and managers gives birth to the earnings management which affects the disclosure of financial statements. Previous studies in banking industry suggest an optimistic association among a financial firm's expense and earnings, it shows that banks seek income smoothing. Anandarajan et al. (2003) and El Sood (2012) found evidence of earning management by using loan loss provisions. Banks use more earning management through spending more in order to get a better outcome

(Ahmed et al., 1999; El Sood, 2012; Kanagaretnam et al., 2005). Banking stocks are more subject to fluctuation than any other stocks due to change in firm performance. Bornemann et al. (2012) examine earning management using a sample of German banks. This study confers whether banks raise net income through without loan loss provisions in relation to the earlier period in order to achieve lower outcome variability.

Earlier research was mainly concerned with the influence of the capital market for public companies only, Beatty et al. (2002) was the first researcher who separately studied earning management in private and public sector banks. She studied earning manipulation in public sector banks and private sector banks of America by conducting a research on the increasing &the decreasing level of small earnings. Where she found that public sector banks are manipulating more earnings in terms of increasing small earnings which was more than expected and decreasing less small earnings than expected. Although reported level of decreasing small earnings for private banks was little bit smaller than expected however she showed that comparatively public sector banks are reporting less decrease in small earnings than private banks. Hence she evidenced that public sector banks do more earning manipulation by using their discretion in loan loss provisioning, by reporting less loan loss provisions in particular year they report increased earnings.

Later on conducted researches had started to scrutinized earning manipulation in an organization from the angle of public/private ownership (Coppens & Peek 2005, Van Der Bouwhede et al. 2003, Arnedo et al. 2007) and they found this angle significant. Arguments given by above mentioned references make it clear that public sector banks do more earning manipulation in comparison to the private sector banks. (Fama & Jensen, 1983) support private sector banks with the argument, that in comparison to public sector banks generally private banks are smaller and their share-holding base is also small rather most of the time majority of shareholdings retained by the promoters of the banks. Because there are few shareholders who have bested interest in the bank therefore they believe in retaining the shares rather disposing their positions, resultantly less frequent trading observed in the shares of these banks (Nagar et al. (2001). (Beatty & Harris, 1999) also supports above discussion about shareholding of a private bank by adding their observation that most of the shareholders in private banks are participating even in the management of the bank. They are dealing with day to day operations of the business and they are having reach internal information even though they are not interested in buying and selling of shares rather they are having a long run interest in the business.

Due to having rich internal information as a promoter and because of participating in the business activities of concern as a manager, the shareholders of these private banks are very much aware about the real situation of business therefore they don’t show any interest in earning manipulation. Not relying on this kind of manipulative accounting figures rather they show their interest in the real performance of concern (Ke et al., 1999). Although due to small size and direct involvement of shareholders as management of the banks reduces the issue of agency cost to a great extent but still there is no clear absence of agency cost and resultant earning management. Rather it has changed its dimension, now it leads to window dressing, (Bowen et al, 1995) says management still manipulates earning, however now they manipulate to manage claims of internal employees and outsiders suppliers along with avoiding interventions of outsiders authorities in the business.

In another research Beatty et al. (2002) covers private and public sector banks of the USA and examine all the aspects associated with the loan and gains which comes in the short term, where they found most of the banks use discretionary part of loan loss provisioning component as their tool to smoothen their earnings over the period of time and resultantly maintain their market position.

Financial institutions and banks are different characters from the other firms that sway they are so often excluded from research on earnings management. (Peasnell, Pope and Young, 2000). There are lots of studies which are focused on the earning management by banks. These studies basically focused on a tool of earning management that is loan loss provisions (LLPs). It's influence on earning because loss loan provisions are quietly large accrual for banks. These provisions are basically focused for adjusting bank loan loss reserves on a loan portfolio to reflecting expected losses in future.

There are certain incentives for banks to manage their earnings due to the following reasons. Primary approach tries to finds discretionary accruals which is based on the relationship of hypothesized explanatory factors & total accruals Which model is using in this approach called total accruals model (as an example Healy model [1985] & Jones model [1991]). In secondary approach Specific accrual is used as a model to test earning management specific accrual model basically focused on a specific industry where substantial judgement required and single accruals or set of accruals is considerable. To observe the accrual behaviour all over the specific benchmark called third approach. For considering the behaviour of research specific accrual research is suitable for research. That’s way focused on a single industry categorized by specific accruals of industry. In earning management research samples are excluded in financial institutions and banks. They have basically differ accrual process it’s not probably be catched through total accrual model. Based on this, for earning management loan loss provisions wanna be a not so much effective tool according to Pérez, Salas and Saurina (2006), in Spanish situation. Authors are confirmed for earnings management at Spain’s bank they have very described set of rules of LLPs instead of that for earning management, management used loan loss provisions. The adoption of IFRS is a more principle-based approach, and It is useful for accounting standard setters to counter management using LLPs to their discretion. Comprehensive disclosure may be beneficial in achieving this (Pérez, Salas and Saurina, 2006, p. 25). Generally it can however be anticipated that under IFRS increase in disclosure requirement will result in declined earnings management. Here practical studies examining the relationship among earnings management& disclosures. Lobo and Zhou (2001) have observed the association among disclosure qualities of the U. S. companies data sample & discovered substantial adverse relationship. It is observed that reduced disclosure requirements is used in discretion over earnings.

The conclusions of this study are parallel to the studies undertaken on the banking sector (Ismail *et al.*, 2005; Elleuch and Taktak, 2013; Amidu and Kuipo, 2015; Alam and Brown, 2015; Leventis and Dimitropoulos, 2015) and offer the existence of revenue levelling. The results indicate a substantial relationship among practices of earnings management & performance of capital markets. The regression results demonstrate a substantial relationship among the capital market performance indicators and corporate governance system. Conclusions of the current study offer an association among earnings management practices and firm’s performance of corporate governance factor and establishing an association between the three factors, explicitly in case of Indian commercial banks.

2. DATA COLLECTION AND METHODOLOGY OF RESEARCH

This paper extends previous empirical studies to show the impact of earning management in the banking industry on banks performance. The banking industry has a great influence on the stability of the global financial system. Moreover, banks have considered a main player during the recent financial crisis. This shows the importance to investigate the association between earning management and performance in the banking industry. The initial sample of this study consists of all Indian banks over the period 2010-2017. After imposing restrictions to all banks with necessary data to analyse our main variables of interest, we end up with a final sample consists of 240 bank year observations that representing 30 Indian

banks, spanning over 8 years from 2010 to 2017. We collect the financial data and date concerning loan loss provision from DataStream to database. Any missing data were collected from the annual financial reports.

Here we studied 30 private and public sector banks 240 annual and corporate governance reports for the covered 8 years. Our methodology is similar to Beatty et al. (2002) where discretionary accruals are used as a proxy for the quantification of earnings manipulation, we have used panel data regression which covers entire considered data. We simply run an OLS regression and regress discretionary part of loan loss provision with other independent variables, the formula used to calculate discretionary accruals is given below which is taken from Beatty et al. (2002):

DLLPit = LOSSit - (α + β1LASSETit + β2NPLit + β3LLRit + β4LOANRit + β5LOANCit + β6LOANDit + β7LOANAit + β8LOANIit + β9LOANFit +εit)

This above mentioned model was used by the Beatty et al. (2002) in American banking system, where it shows suitability for the American banking environment, but when it comes to Indian context, then due to the different banking environment and different reporting system in both the countries, we have to make some changes in this existing model according to the requirement of the Indian banking system.

Now we need a suitable model which can address earning manipulation in Indian context, hence we use model used by Kumari, P., & Pattanayak, J. K. (2017) where they have made some changes according to the specific requirements of the Indian banking system. To address the specific issues in the Indian banking system they have added some more variables into the above mentioned existing model of Beatty et al. (2002), these variables are short term loan, bad debt written off, long term loan, unsecured loan, secured loan, advance to public sector, and loan to priority sector. By incorporating these above variables into the model, hence updated model becomes workable in Indian context, which is given below in the form of equation (1).

DLLPit = LOSSit - (α + β1LASSETit + β2NPLit + β3BDW+ β4LLRit + β5TLOANit + β6STLOANit + β7SLOANit + β8UNSLOANit +β9LOANPSit + β10ADVPSIit + β11LOANFit +εit) (1)

Where, i = represent specific bank or identity for these banking companies cross-sectional;

t = denotes covered time period (2010 to 2017) ;

DLLP = it is discretionary part of loan loss provision in form of percentage to total loans;

LOSS = Represents total loan loss provision maintained by a bank in percentage form of total loans;

LASSET = Represents logarithmic form of total assets;

NPL = Percentage of non-performing assets to the total loans;

BDW = Amount of bad debt written off as a percentage of total loans and advances;

LLR = allowances allowed for loan losses in form of total loan loss percentage;

TLOAN = Represents percentage form of term loan against total loans;

STLOAN = Represents percentage form of short term loan against total loans;

SLOAN = Represents percentage form of secured loan against total loans;

UNSLOAN = Represents percentage form of unsecured loan against total loans;

LOANPS = Represents percentage form of loan to priority sector against total loans;

ADVPS = Represents percentage form of advances to public sector against total loans;

LOANF = Represents percentage form of loan to foreign country against total loans;

εit = error term.

This above mentioned model also distinguish between public sector banks and private sector banks and controls their differences, where it reads 1 used for public sector banks and 0 used for private sector banks.

3. RESULTS AND ANALYSIS

This section discusses processed results and their analysis with the help of below mentioned tables.

3.1 Descriptive Analysis

Below mentioned table 1 shows descriptive statistics for the discretionary accruals, which is used as a substitution to the measurement level of earning management in private and public sector banks in India. On the basis of results reported in table 1 we can conclude that both private sector banks & public sector banks are indulge in income increasing practices of earning management and they have maintained negative amount of discretionary accruals. Moreover, we can also comment on the role of the discretionary part of loan loss provisioning, where we find that it also adds to the higher earning management.

Table 1

	Descriptive Statistics			
	Min	**Median**	**Mean**	**Max**
Discretionary loss loan provision	0.005	0.000	0.000	0.008
Profit after tax	0.155	0.818	0.211	0.183
Return on assets	0.010	0.845	0.899	2.790
Return on equity	0.340	14.525	13.752	38.600
Return on investment	0.210	6.292	6.645	32.860
Total Assets	9.947	14.030	14.004	17.355
Capital adequacy ratio	9.630	12.850	13.680	56.410
PBDITA	0.120	0.955	0.197	0.242
Yield	0.000	9.785	13.826	63.850

3.2 Correlation Analysis

Existed correlation among different considered profitability variables is shown by the table 2. Where the price earnings ratio (P/E) is showing a high correlation with ROA (return on assets) and CAR, and ROI (return on investment) is highly correlated with ROE (return on equity), while other variables are showing a moderate correlation with each other.

Table 2

			Correlation Analysis							
Variables	**DIPR**	**PAT**	**ROA**	**ROE**	**ROI**	**TA**	**CAR**	**PBDITA**	**P/E**	**Yield**
DIPR	1.000									
PAT	0.014	1.000								
ROA	-0.014	-0.072	1.000							
ROE	0.052	-0.478	0.331	1.000						
ROI	0.044	0.007	0.145	0.689	1.000					
TA	0.009	-0.061	-0.003	0.536	0.816	1.000				
CAR	0.000	0.390	0.694	0.099	0.106	-0.075	1.000			
PBDITA	0.032	-0.412	0.129	0.341	0.000	-0.042	-0.198	1.000		
P/E	-0.044	0.141	0.780	-0.005	-0.088	-0.166	0.706	0.003	1.000	
Yield	-0.013	-0.404	0.207	0.264	-0.225	-0.247	0.096	0.221	0.218	1.000

3.3 Regression Results

Reported results by the regression equation (1) shows different results for private sector banks & public sector bank hence it distinguish them in their earning management practices. Although these results also make it clear that capital market disciplines has an impact on earning management practices of the Indian banking industry, however, this impact is different for public sector and public sector banks.

Our study shows resemblance with the findings of Sarkar et al. (2014) and claims the existence of earning management practices in Indian banking industry across the public and private sector banks. Though we used accrual model given by Beatty et al. 2002 and updated by Kumari, P., & Pattanayak, J. K. (2017) which is different in comparison to improved Jones model used by Sarkar et al. (2014).

Regression results shown in table (3) specifically for public sector banks, presents significant relationship between the market measures of banks performance and their earning management practices which could be understand by the results for representative variables like Yield and PE ratio. Contrary to the results for private sector banks & public sector banks shows relationship among PAT (profit after tax) and earning management practices, hence these results support the claims that private owned banks are more interested in real profits of the organization.

Table 3

Effect of Public Sector Banks on Earnings Management		
Dependent Variable : Discretionary Loss Loan Provision		
	Within	**Between**
Independent variables:		
Public sector banks	0.000621	
	0.5	
Profit after tax	-2.04E-08	-9.00E-09
	-2.29	-0.25
Return on assets	0.000911	-0.00189
	0.94	-0.75
Return on equity	3.04E-05	0.000123
	0.53	0.78
Return on investment	-0.00019	0.000221

Table 3: Contd.,		
	-2.36	1.34
Total Assets	-0.00014	3.93E-06
	-0.31	0.01
Capital adequacy ratio	-1.51E-06	0.00022
	-0.03	1.07
PBDITA	-5.65E-09	7.89E-10
	-4.65	0.34
Profit earnings ratio	-2.1E-05	7.93E-05
	-1.15	1.1
Yield	0.000241	-7.6E-05
	2.83	-0.21

4. CONCLUSIONS

This study investigates the practices of earnings management among private sector and public sector commercial banks. Based on 240 firm-years observations consists of 30 banks spanning over 8 years from 2010 to 2017, we ascertain that on average public sector banks are unlikely be engaged in earnings management consists with the prediction of their greater internal and external monitoring such as strong corporate governance and greater analyst forecast. It confirms the existence of income hikes the earning management in cases of both. It’s noticeable that the distinction in business inclination into public sector and private sector banks effect the shape of practices of earnings management by categories of both the banks since its acknowledged that loan loss provisions are mostly use by public sector banks for earnings management. Limitation of the study it only considers few banks of private and public sector for the research. Mainly higher number of the commercial banks from private sectors bank and public sectors bank provides a conclusive and improved result.

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